AMO REPORTS 82-7

RENT REVIEW IN ONTARIO

THE ASSOCIATION OF MUNICIPALITIES OF ONTARIO
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To the Municipal Clerk:

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RENT REVIEW IN ONTARIO

1. INTRODUCTION

Legislation governing rent increases has been in effect in Ontario since January 1, 1976. At its inception, the Rent Review Program was conceived to be a temporary measure to restrain unjustified increases in a time of rapidly escalating rent increases.

In the past year, many large urban centres have been confronted with very low vacancy rates, due to the absence of rental construction since the termination of many Assisted Rental Programs (ARPs) coupled with rising mortgage interest rates. Landlords are having more difficulty in meeting their costs within the annual 6% increase permitted without application to Rent Review. At the same time, many low and moderate income people are having more difficulty finding decent quality, affordable rental accommodation.

The Association of Municipalities of Ontario is concerned about the future of the rental housing market and the effect that Rent Review is having on private rental investment and construction (and supply) and affordable housing availability. AMO believes that the current situation with respect to these two areas affected by Rent Review must be corrected.

The intent of this AMO paper is to ascertain whether Rent Review can assist in ensuring a good supply of affordable decent quality rental accommodations that will meet the needs of residents in our municipalities.

2. BACKGROUND TO THE RENT REVIEW PROGRAM

The Rent Review Program was conceived as a temporary program of limiting rent increases, and complemented the Federal government's Anti-inflation Program.

Although the Program was designed to prevent unjustified rent increases, rent review does not control rents. Rather, more significantly, it controls only the increases in rent.

Rent Review was originally structured to end July 31, 1977; however, it was extended when the original act was replaced by The Residential Tenancies Act R.S.O. 1977. During the first 27 months of the program, rent increases of up to 8 percent per annum were permitted. Commensurate with Anti-Inflation Board guidelines set out by the Federal government, the maximum increase became 6 percent per annum in October, 1977. Not all rental accommodation, however, is covered under the program; for example, rental units built after January 1, 1976, luxury rental units (over $750 per month) and, public and non-profit housing units are exempted from the 6 percent ceiling.[1]

If a landlord wishes to raise rents over the 6 percent ceiling, for accommodation controlled by Rent Review, he/she must file for permission to do so with the Residential Tenancies Commission. The Commission is responsible for determining whether the increase is justified, based on a cost pass-through plus financial loss and hardship analysis.[2]

3. INVESTMENT CONSTRUCTION AND SUPPLY IN THE PRIVATE RENTAL MARKET

The core of the Rent Review Program is based on a "cost pass-through principle", that is, the principle that rents can be increased only to the extent that costs have risen. The implication, theoretically, is that the real profit of the landlord will not be allowed to increase.[3]

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1 The Residential Tenancies Act, Section 134.

2 The Residential Tenancies Act, Section 131 (1),(2) and (3).

3 Exceptions to this, i.e. financial loss and hardship are contained in Section 131 (1),(2) and (3) of The Residential Tenancies Act.

This carries important implications because a controlled profit violates the long-established pattern of returns in the industry whereby buildings start out in their initial years with low, or negative, returns and the profit margin improves over time. Hence, many landlords, particularly those who built in 1974 and 1975, operating rental accommodation under Rent Review may not be obtaining an adequate financial return. However, landlords can apply for increases over 6 percent and many are. At the same time, the 1980 Ministry of Housing Rental Market Survey released in March, 1981, indicates that many tenants, i.e. 18.2% in Metro Toronto and 45.7% in Sudbury, had no rent increase in 1980.

Rent Review is not the sole reason for the diminishing supply of rental units. The supply problem is exacerbated by the fact that labour, land and material costs as well as interest rates have risen drastically. The combination of cost factors and Rent Review has made other forms of investment, i.e. commercial development, more attractive to potential investors. At the same time, it must be recognized that the above-mentioned cost factor problems were a major concern even before Rent Review came into effect and even as far back as the late 1960's much investment was already shifting to commercial development. Furthermore, other cost factors such as inflation are beyond the control of the housing industry and are exerting pressure on all areas of the economy.

Not only in potential investment has the capital been side-tracked from rental accommodation, but, increasingly, rental holdings already in existence are being transferred to a non-controlled legal status such as, condominiums and cooperatives and being sold, not rented, in this form. The landlord can therefore get out of providing rental accommodation, immediately make a profit by selling the converted owner-occupied unit, and then invest the money into more lucrative areas. In addition, the tendency to withdraw from investing in rental housing is even greater given the fact that most rental housing has been financed on five year term mortgages.

Therefore, if landlords are faced with the prospect of higher financing costs, that may not be totally offset by rent increases, with interest rates being so high, they will not want to keep their capital in the rental market. In the meantime, many municipalities have found it necessary to either ban or limit conversions.

On the other hand, if a landlord is functioning with a cost-revenue imbalance and does not convert his holding to owner-occupied housing, nor receive approval to increase his rents by a larger percentage, his alternative will be to cut back on maintenance to the lowest level possible, hoping it will at the very least be commensurate with his losses. However, in Ontario, many landlords have been getting their justifiable rent increases over 6 percent and maintenance cut-backs have not, as yet, become a major problem.

The decrease in the supply of rental accommodation has created a situation wherein demand for rental units substantially exceeds the number of rental units available. This is clearly reflected in vacancy rates.

The vacancy rate in Canada that provides flexibility is between 3 and 4 percent. The market is thought to be functioning well when it is in that range and indicates that builders and investors are keeping up with market demand. However, vacancy rate statistics (see Appendix One) released by CMHC for metropolitan areas in Ontario indicate that the market is not functioning well. In some municipalities, such as Toronto, the low vacancy rate is critical. In others, such as Windsor, the high vacancy rate is critical.

There is a strong inverse relationship between rent increases and vacancy rates because generally, as vacancy rates decline, rents can be increased more easily and more rapidly while when vacancy rates rise it becomes very difficult to obtain adequate rent increases to meet rising operating costs. "In a free market environment, therefore, investors move into and out of rental construction in response to

changing supply-demand conditions in the rental market which determine their ability to obtain an appropriate rental level-vacancy situation that would make new rental construction viable."[4]

In a rental market subject to government intervention (i.e. Rent Review), however, the market adjustment system is either weakened or removed by the inability of rental levels to respond to supply and demand conditions. Although the inverse relationship between vacancy rates and rent increases still exists, the extent to which this relationship can affect rental levels is limited by the 6 percent maximum increase of Rent Review legislation. As a result, as the vacancy rate declines, rents can only increase by the amount allowed, 6 percent (based on the assumption that higher rent increases are not petitioned for), which may not be sufficient to off-set rising capital and financing costs for new rental construction. A gap will therefore develop between the rental levels required to make new construction viable and the actual rent levels that can be charged. This means that under Rent Review market adjustment is weakened by the inability of rents to adjust to supply and demand and determine the viability of new construction.

Many authorities agree that Rent Review is one of the major factors behind the declining supply of rental units because of the cost-revenue imbalance that is created. However, the assumption that removing Rent Review will increase supply will have to be examined more carefully. For example, supply could also quite possibly decrease because of the fear that removing Rent Review would be politically unacceptable and brought back in with the next election.

AMO firmly believes that private rental housing construction will not occur without sufficient government incentive programs. The rental market has always depended upon government subsidies. In recent years more emphasis has

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4 The Viability of Rental Construction, the Effects of Rent Controls, and Strategies for a Smooth Return to a fully viable rental sector. Dr. E. Wayne Clendenning. November 1980. page 18.

been placed on programs that provide incentives to the private sector rather than publicly-assisted housing programs. Therefore, public monies, in the form of grants, loans and tax incentives, once used for social housing programs, are now being diverted into the private sector to encourage construction.

There are currently two government programs which have been designed to encourage private rental construction and increase the supply of rental units. The Federal Multiple Units Residential Building Program (MURB) is a tax shelter scheme that allows an investor to create a tax loss by deducting depreciation on the building from rental income, then use the loss to reduce taxes from other income. The Ontario Rental Construction Loan Program (ORCL) offers interest-free loans to investors in order to stimulate private rental construction in areas with low vacancy rates.

AMO believes that there are three important reasons why these current private rental housing programs do not adequately meet the needs of the housing market.

First, external factors, most significantly, climbing interest rates, have had such profound effects on rental construction that there will not be much willingness on the part of developers to invest in rental construction. Therefore, private incentive programs will not be as successful as anticipated.

At the same time, private sector incentive programs do not necessarily take into account the "lag in supply" factor. Buildings cannot be constructed overnight. It takes an estimated 3-5 years for a building to go through the approval process and be constructed.

Finally, and most importantly, private sector incentive programs do not reach those in most need of assistance. Existing provincial policies may, in the short run, increase supply but not necessarily supply appropriate, affordable housing.

4. AFFORDABILITY

The issue of affordability has become of great concern when discussing the effects of Rent Review. Rent Review has not been a program to provide low-income housing and many low-income people, who may spend more than 35 percent of their income for shelter, cannot afford their rents even with Rent Review in place. At the same time, in areas of low vacancy rates, some moderate income people, who cannot at present afford to move into owner-occupied units because of high mortgage interest rates, are finding it increasingly difficult to obtain adequate rental accommodation within their budget limitations. These households, both low and moderate income, face even greater difficulties if Rent Review legislation is changed without alternative programs in place that are geared to assist them.

The problem exists because people regard housing as being a basic human right, but, at the same time, many see it as a business, money-making venture.

There are those of the former who recognize the need for helping lower income people afford adequate shelter, but see it as being strictly an income-related, rather than a housing, problem thus requiring government involvement by way of shelter allowances rather than through the housing market.

However, if Rent Review was removed and replaced by solely a shelter allowance system, the whole purpose of the exercise would be defeated because the shelter allowance would just be taken up in inflationary increases in rent.

AMO believes that the problem of low-income renters is a social housing problem that will exist whether Rent Review is in force or not. The Association contends that this limited problem should not be justification for the retention of a system of rent control that seeks to benefit all renters regardless of their ability to pay rent.

Although the federal and provincial governments, as well as municipal governments, are involved in some social housing programs such as, the Private Assisted Rental Program, Rent Supplement Program and municipal and private non-profit cooperatives, these types of programs have become virtually secondary to private sector incentives.

AMO believes that in a time of limited public funds, beneficiaries of public money should be those in need of it, i.e. low income people. It is AMO's objective that everyone be assured accommodation that is affordable to them.

5. RENT DECONTROL

AMO believes that Rent Review has not been very effective in Ontario. More landlords are now applying for and getting increases above the 6 percent ceiling of Rent Review (see Appendix Two). In the earlier years of the Program, landlords were keeping rents down by not bothering to apply for justified rent increases, in hope of the program being cancelled particularly because it was initially conceived to be an eighteen month program. What seems to be happening now is that landlords are accepting the reality of Rent Review as a permanent policy and are applying for higher increases to meet, at the very minimum, their costs. Hence, in reality Rent Review does not necessarily keep rents down, especially when external factors have also exerted much pressure on the housing market as a whole.

At the present time, AMO contends that Rent Review is probably not as important a problem as mortgage interest rates. High interest rates have deterred much construction incentive in Ontario. As well, many people who would have been moving into the owner-occupied housing sector cannot afford such high mortgage interest rates and have been forced to stay in rental accommodation. In this respect, AMO urges that measures be taken to lower the interest rate to encourage investment.

There are three major arguments why Rent Review should not be removed. First, there is the problem of low-moderate-income groups who are unable to pay high rents at present and would not be able to afford further rent increases after decontrol. At the same time, retention of rent controls in a low vacancy rate market will only increase the shortage of rental housing and make it more difficult for these groups to find accommodation of any type.

AMO firmly believes that the plight of lower-income renters is a social housing problem that should be corrected through government social welfare programs, and in particular, the provision of more subsidized social housing units. Present government assistance and incentive programs, such as the ORCL and MURB programs, do very little to help lower-income groups because they are aimed primarily at providing market housing which is beyond the reach of low-income renters and not covered by Rent Review legislation.

Therefore, AMO recommends:

1. That additional funding for social housing programs be provided to increase the supply of affordable rental accommodations for low and moderate income people.

2. That the ORCL Program and MURB Program be cancelled and funding for these programs be redirected to social housing programs.

The second argument against rent decontrol is the concern that, by allowing rents to move upwards to levels required for new construction viability, the owners of existing units who have low capital and financing costs would benefit by receiving an excessive return on their earlier investments in rental property.

This is based on a view that investors should receive increases sufficient only to cover increased costs and maintain a fixed return on their original equity investment. However this viewpoint does not take into account the investor's need to have cash and income flow and capital values that keep up with inflation so that his return on investment remains at

least constant over the term of his investment. Furthermore, if an investor cannot achieve a constant return through rental construction, he will invest in other areas or attempt to convert existing units to owner-occupied.

The final argument against decontrol deals with the need for a large catch-up increase in rent levels in order to restore viability. Rent decontrol could place hardship on renters if it occurred suddenly before their incomes could adjust to meet the higher rental levels.

However, this problem is only a concern in markets with very low vacancy rates. In areas with high vacancy rates, supply-demand conditions will limit the rise in rent levels, even when Rent Review is removed, and no sudden or large adjustment would occur. A gradual upswing in rents would only develop when the market adjustment process restarted and eventually lowered the vacancy rate to a point where rents would begin to rise towards viability levels.

On the other hand, in areas with low vacancy rates, a sudden removal of Rent Review could result in very rapid rent increases. The increases would only stop when the market adjustment mechanism begins to result in a substantial increase in supply of rental units to meet the ongoing demand. Under these circumstances, rent levels could move to levels even higher than required for viability in the short term because of excess demand until new supply is created. Affordability would be a problem for many people.

AMO believes that most rental markets in Ontario would function better without a system of rent controls. Rent decontrol would restore the market adjustment mechanism in the rental market that should provide appropriate levels of rental housing over the long run and rental levels would reflect the ongoing changes in capital financing and operating costs.

At the same time, AMO recognizes that because vacancy rates differ across the Province, a universal approach to the rental market is not appropriate and policies should be formulated on a market by market basis. In this respect, AMO recommends that the following steps be taken towards phasing-out Rent Review in the Province of Ontario:

3. That rental units in municipalities with vacancy rates above 3 percent no longer be subject to rent control.

4. That Rent Review be maintained in municipalities where the vacancy rate is below 3 percent until such time as vacancy rates are normal--above 3 percent at which time recommendation #2 would take effect.

The prospect that controls were going to be removed completely would provide confidence to investors that the rent levels on new construction would not continue to be undercut by rent levels on existing units after vacancy rates increased.

If Rent Review is phased out, AMO feels that the tenant should still be guarded from exorbitant rent increases and security of tenure should be guaranteed so that a landlord could not force a tenant out through excessive rent increases. Therefore, AMO recommends:

5. That the Province of Ontario implement an appeal system whereby any tenant could request a review of any rent increase felt to be excessive.

6. That a standard "notice of rent increase" form be developed which would contain within it notification to the tenant of his or her right to appeal and the appeal procedure.

6. CONCLUSIONS

The rental housing situation in Ontario is going to get worse before it gets better. Rental housing cannot be built overnight. Therefore, steps must be taken now to correct the present problems that face the rental housing market. AMO believes that Rent Review has not been an effective measure for keeping rents affordable because it has not necessarily

helped those in most need of assistance: the lower income people who need social housing units that they can afford. In this respect, AMO feels that more emphasis should be placed on increasing the supply of social housing units thereby directly benefitting those in most need of lower-priced, affordable, rental accommodation.

AMO recognizes that financial incentive for landlords to invest in rental accommodation has been progressively undermined by Rent Review legislation as well as other external factors that have had great impact on the housing market as a whole. For this reason as well, Rent Review must be phased out. At the same time, AMO believes that a rent monitoring mechanism could prove to be a beneficial check on rents once Rent Review is no longer warranted by the market.

AMO recognizes that the difference in vacancy rates is an indicator that rental markets are very different among municipalities across the Province. Therefore, a market-to-market approach is more feasible in the rental housing market. In addition, AMO believes that municipalities should be consulted prior to any changes to The Residential Tenancies Act in order to ensure that any changes made are responsive to local needs and circumstances.

Therefore, AMO recommends:

7. That municipalities be consulted about changes to Rent Review legislation prior to their occurrence.

Municipalities must ensure a good supply of decent quality, affordable rental housing to meet the needs of their inhabitants.

7. SUMMARY OF RECOMMENDATIONS

1. That additional funding for social housing programs be provided to increase the supply of affordable rental accommodations for low and moderate income people.

2. That the ORCL Program and MURB Program be cancelled and funding for these programs be redirected to social housing programs.

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